IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-1263

THE FIRST NATIONAL BANK OF CHICAGO,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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INDEX TO PETITION

List of Authorities Cited

Decisions

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To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

The First National Bank of Chicago, petitioner herein (First National) respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit, entered in the above case on December 17, 1976.

OPINIONS BELOW

The opinion of the United States Tax Court is reported at 64 T.C. 1001 (1975). The opinion of the Court of Appeals

for the Seventh Circuit is reported in 546 F.2d 759. Both opinions are printed in the Appendix hereto.

JURISDICTIONAL GROUNDS

The decision of the Court of Appeals was rendered on December 17, 1976. A timely petition for rehearing was denied on January 31, 1977. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(a)(1).

QUESTION PRESENTED FOR REVIEW

The sole question presented by this case is whether a bank's computation of the deductible addition to its reserve for bad debts, made pursuant to the bank's reasonable interpretation of published rulings dealing with the subject, is to be sustained. The Court of Claims so held in *State Bank of Albany* v. *United States,* 530 F.2d 1379 (Ct. Cl. 1976), as did the Court of Appeals for the Seventh Circuit in *Pullman Trust & Savings Bank* v. *United States,* 338 F.2d 666 (7th Cir. 1964). On the other hand, the Court of Appeals for the Sixth Circuit held to the contrary in *Akron National Bank & Trust Company* v. *United States,* 510 F.2d 1157 (6th Cir. 1975), as did the Court of Appeals for the Seventh Circuit in the instant case. Resolution of this conflict is the primary reason for granting this petition.

STATUTE AND RULINGS INVOLVED

The statutory provision involved in this controversy is section 166(c) of the Internal Revenue Code of 1954, 26 U.S.C. §§ 166(c). In addition, Mimeograph 6209, 1947-2 C.B. 26; Revenue Ruling 65-92, 1965-1 C.B. 112; and Revenue Ruling 68-630, 1968-2 C.B. 84, are involved. The statute and rulings are quoted in the Appendix hereto.

STATEMENT OF THE CASE

First National is a national banking association. In connection with its banking operations, it serves as Trustee for numerous individual trust, agency and custody accounts. As required by law in accordance with its fiduciary duty as Trustee, First National segregates and accounts for its trust business separately through its Trust Department.

The Trust Department maintains both an income account and a principal account for each separate trust. The income account reflects the amount of cash held for the income beneficiary, while the principal account reflects the amount of cash held for the principal beneficiary. The Trust Department also maintains a securities account for each trust; this account reflects purchases and sales of all types of securities held by the trust in unit rather than dollar amounts. Both the income and principal accounts reflect all cash increases and decreases in the respective accounts. Such separate accounting for principal and income is required by law.

At any point in time, either the income account or the principal account of a particular trust, or both the income and principal accounts, may have a negative balance. Negative balances occur whenever the particular income or principal account contains insufficient cash to cover charges against the account. These shortages are customarily referred to as "overdrafts." Regulations of the Comptroller of the Currency require that the Trust Department borrow from the commercial loan department of First National, or from another appropriate source, sufficient funds to cover all overdrafts. This is done on a daily basis.

The amounts borrowed to cover these overdrafts (Trust Department Advances), under regulations of the Comp-

troller of the Currency, must be and are included in the category of "other loans" for purposes of First National's call report to the Comptroller.

The aggregate of the balances in the individual trust principal and income accounts (including any amounts borrowed to cover overdrafts) are included (as deposits) in the Federal Deposit Insurance Corporation base on which First National pays assessments and are included (as deposits) in the calculation of First National's reserve requirements under the Federal Reserve system.

Since 1947, First National has followed the Commissioner's rulings setting forth the methods applicable to commercial banks in the computation of their reserves for bad debts, beginning with Mim. 6209, 1947-2 C.B. 26. Since and including its taxable year ended December 31, 1965, First National has utilized the uniform reserve ratio method provided by the Commissioner in Rev. Rul. 65-92, 1965-1 C.B. 112, in computing its bad debt reserve. In computing its outstanding loan base at year-end for this purpose, First National has included, in each of said years, its Trust Department Advances outstanding.

The Commissioner determined that the amount of First National's Trust Department Advances must be excluded from its loan base in computing its deductible addition to its reserve for bad debts for the 1968 taxable year. After the issuance of a statutory notice of deficiency, First National filed a petition with the United States Tax Court seeking a redetermination of the deficiency resulting from the Commissioner's determination.

The Commissioner asserted that, within the meaning of section 9 of Revenue Ruling 68-630, 1968-2 C.B. 84, Trust Department Advances were "not representative of the bank's ordinary portfolio of outstanding customer loans"

and that they should, therefore, be excluded from the loan base. In looking at that section of the Ruling, the Tax Court held that it

> . . . must be interpreted in the context of the two sections of the ruling which precede it. . . .
>
> Sections 7 and 8 distinguish between trading and investment on the one hand, and the lending aspects of a bank's activities on the other. In issuing Rev. Rul. 68-630 it was the Commissioner's purpose to exclude from the loan base obligations acquired by the bank for trading or investment purposes. Sections 7 and 8 give effect to this purpose in respect of several specific kinds of obligations enumerated in those sections. *Section 9 is a broadly phrased rule of exclusion based upon the principle that underlies the two preceding sections. The cash payments represented by Petitioner's TDA account are plainly in the nature of customer loans rather than of debt securities or money market obligations. They therefore ought not to be excluded from petitioner's loan base under section 9.* [64 T.C. at 1007-8; emphasis supplied]

The Court of Appeals disagreed with the Tax Court's interpretation of section 9, and approved of a subsequent decision of that Court holding that section 9 constitutes a separate ground for exclusion of loans from a bank's loan base beyond those exclusions set forth in earlier sections of Revenue Ruling 68-630. The Court of Appeals then held that "the question under Section 166(c) and Revenue Ruling 68-630 is whether the Commissioner's view is reasonable rather than whether the taxpayer's view is reasonable." With that holding, the Court went on to say "The principal question then becomes whether it was reasonable for the Commissioner to conclude that these TDAs were not representative of taxpayer's ordinary portfolio of outstanding customer loans so that they must be excluded from

the loan base." The Court's ultimate holding was that "The reasonableness of the Commissioner's conclusion is apparent. . . ." The Court did *not* hold that the petitioner's contrary conclusion was not also reasonable.

REASONS FOR ALLOWING THE WRIT

I

THE BASIC RULE OF LAW ASSERTED BY THE COURT OF APPEALS IS IN CONFLICT WITH A DECISION OF THE COURT OF CLAIMS AND A PRIOR DECISION OF THE COURT OF APPEALS FOR THE SEVENTH CIRCUIT

In the Commissioner's reply brief in the Court of Appeals, he conceded that

> . . . the ruling does not specifically address advances such as those here involved. The application of the Ruling here thus involves matters of judgment and interpretation. [Reply brief, p. 6]

Respondent asserted, however, and the Court held, that if the interpretation made by the respondent were reasonable, it must be sustained, regardless of the reasonableness of the interpretation made by First National. This holding is in direct conflict with the very recent decision of the Court of Claims in *State Bank of Albany* v. *United States*, 530 F.2d 1379 (Ct. Cl. 1976).

That case involved whether the taxpayer was entitled to include in its loan base for the year in question certain New York State notes. Respondent had issued a ruling (Mimeograph 6209) which required banks to exclude from the loan base "Government insured loans." In a later ruling, not retroactive to the year in question, this had been

specifically defined to include State obligations. The question before the Court of Claims, therefore, was whether the Commissioner's determination that State obligations could not be included in the taxpayer's loan base for the prior year should be sustained.

The Court of Claims cited its decision in *North Carolina National Bank* v. *United States*, 345 F.2d 544 (Ct. Cl. 1965), and said:

> . . . It is well established that Mim. 6209 is the Commissioner's exercise of discretion authorized by Sec. 166(c). While it does not have the force and effect of law or regulation, it is a rule of general application binding on the Commissioner and the taxpayer. *North Carolina Nat'l Bank* v. *United States*, 345 F.2d 544, 170 Ct. Cl. 765 (1965). As decided in that case, the promulgation of Mim. 6209 and a taxpayer's timely election to follow it brings into effect something analogous to a binding contract. [530 F.2d at 1381]

Just as in the instant case, the ruling before the Court did not "specifically address" State obligations, although it employed what the Court called an ambiguous term, "Government insured loans." The Court of Claims stated the applicable rule of law, with which the decision of the Court of Appeals here conflicts:

> . . . Where a provision in a contract is susceptible of more than one reasonable interpretation, the rule of *contra proferentem* dictates that any ambiguity must be resolved against the drafter of the contract. . . . Mim. 6209 was drafted by the IRS, to be used only at a taxpayer's election, and its effect is as stated above. The analogy of such a pronouncement to a contract of adhesion is much closer than would be the case with any IRS statement meant to be otherwise used. In 1961, plaintiff's interpretation of "Government insured loans" to mean Federal Government was a reasonable reading of the Mimeo. Defendant's use

of the phrase, without any clarifying language by 1961, created what was at best for it an ambiguity which should be construed against the drafter.

> Defendant urges that the Commissioner's decision to exclude New York State short-term notes from the loan base was reasonable since these notes involve "no reasonable risk of loss." Even though being reasonable, he could not vary his agreement. *North Carolina Bank, supra.* [530 F.2d at 1383]

It is at once apparent that the Court of Claims viewed the question before it in a very different light than did the Court of Appeals. To the latter, "the question . . . is whether the Commissioner's view is reasonable rather than whether the taxpayer's view is reasonable." To the Court of Claims, on the other hand, the taxpayer's reasonable construction of the Commissioner's less-than-explicit ruling must be sustained even though the Commissioner's different interpretation thereof might also be reasonable.

The Court of Claims position is in accord with the prior decision of the Court of Appeals for the Seventh Circuit in *Pullman Trust and Savings Bank* v. *United States,* 338 F.2d 666 (7th Cir. 1964), which decision was cited and discussed approvingly and at length in *North Carolina National Bank*. In that case, Judge Will's opinion in the District Court [235 F.Supp. 317 (N.D. Ill. 1963)] was adopted by the Court of Appeals as its own. Judge Will concluded:

> If the position espoused by the Technical Information Release [i.e., that the promulgation of a ruling dealing with bank bad debt reserves constitutes the exercise of the Commissioner's discretion] was not accepted by the Service and the courts, every bank which elects to use the reserve method and Mimeo 6209 would find that its calculation of its reserve for bad debts would be subject to annual review for reasonableness despite fastidious compliance with the Commissioner's directive with respect thereto. Such a result would be intolerable. The Court concludes that Mimeo 6209 is the product of the Commissioner's exercise of discretion as

> authorized by section 166(c) of the Internal Revenue Code and that a computation in accordance therewith is presumed to be reasonable. Accordingly, the defendant would have the burden of disproving its reasonableness. [235 F.Supp. at 323]*

In the instant case, Revenue Ruling 68-630 "does not specifically address advances such as those here involved." [Commissioner's reply brief, p. 6] However, in section 4 of that Ruling, the Commissioner held:

> . . . An overdraft in one or more deposit accounts of a customer is an outstanding loan eligible for inclusion in the loan base whether or not other deposit accounts of the same customer have balances in excess of the overdraft.

If an overdraft in a customer's deposit account is properly treated as an outstanding loan eligible for inclusion in the loan base, it was clearly reasonable for First National to conclude that an overdraft in a trust income or principal account giving rise to a Trust Department Advance should be similarly treated, especially since such Advances are treated as giving rise to deposits for purposes of computing First National's FDIC assessments and reserve requirements. In such circumstances, to subject First National to second guessing by the Commissioner in his annual review of First National's income tax returns would be, as stated by Judge Will, "intolerable." Put in the words of the Court of Claims, First National's interpretation was a reasonable reading of Revenue Ruling 68-630 and, if that Ruling was ambiguous, the ambiguity should be construed against the Commissioner.

* *Pullman* involved Mimeo 6209; Mimeo 6209 was superseded by Rev. Rul. 65-92, which in turn was supplemented by Rev. Rul. 68-630. Each of these rulings constitutes an exercise of the Commissioner's discretion with respect to bank bad debt reserves; *Pullman* cannot properly be distinguished from this case on the ground that Mimeo 6209 was involved there while Rev. Rul. 68-630 is involved here.

The result reached by the Court of Claims and by the Court of Appeals for the Seventh Circuit in *Pullman Trust* is both reasonable and equitable. The position taken by the Court of Appeals in the present case, although it produces greater tax revenues, disregards the well-known legal principle that tax laws should, where possible, be construed in favor of the taxpayer, since the contest between the taxpayer and the Government is an unequal struggle at best.

First National acknowledges that the Court of Appeals opinion, although it conflicts with the prior opinion of the same Court and of the Court of Claims, is supported by the decision of the Court of Appeals for the Sixth Circuit in *Akron National Bank & Trust Co.* v. *United States,* 510 F.2d 1157 (6th Cir. 1975). Indeed, it is also supported by the dissenting opinion of Senior Judge Durfee, in *State Bank of Albany.* However, Judge Durfee's dissent only points up the fact that there is an irreconcilable conflict between *State Bank of Albany* and the Court's decision in this case. Such a conflict merits the allowance of a writ of certiorari to permit this Court to resolve the issue.

II

THIS CASE IS OF EXTREME IMPORTANCE TO THE BANKING COMMUNITY BECAUSE THE DECISION OF THE COURT OF APPEALS IS APPLICABLE TO VIRTUALLY ALL BANKS CONDUCTING A TRUST BUSINESS AND EMPLOYING BAD DEBT RESERVES

The Commissioner has determined, and the Court of Appeals has upheld the determination, that Trust Department Advances are "not representative of the bank's ordinary portfolio of outstanding customer loans." Consequently, such Advances may not be included in the loan base for the purpose of computing the deductible addition to a bank's bad debt reserve.

Inasmuch as banks subject to the regulations of the Comptroller of the Currency which conduct trust businesses are required to handle trust account overdrafts as did First National, this holding affects every such bank which computes the deductible addition to its bad debt reserve by reference to a percentage of eligible loans outstanding. Certainly, any decision with such widespread implications for the banking community should be reviewed by the Supreme Court of the United States, especially where the basis for the decision conflicts with the holdings of other federal courts. The issue in this case presents an important question of federal law which has not been, but should be, settled by this Court.

CONCLUSION

For each of the foregoing reasons, First National earnestly urges that this petition be granted and that this Court's writ of certiorari issue to the Court of Appeals for the Seventh Circuit to review its decision in the instant case.

Respectfully submitted,
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TABLE OF CONTENTS TO APPENDIX

TAX COURT OPINION

THE FIRST NATIONAL BANK OF CHICAGO, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 3408-72. Filed September 3, 1975.

Petitioner, a national banking association, administers numerous trusts through its trust department. In administering the trusts, the said department makes cash payments on their behalf. Each cash payment is charged either to the principal or to the income account of the trust on behalf of which it is made. If a payment exceeds the balance in the account to be charged, the trust department may nonetheless make the payment, obtaining the funds necessary to cover the excess from petitioner's commercial loan department. Such a transaction is undertaken only if petitioner's responsible officers are reasonably certain that petitioner will be reimbursed for the excess. Excess payments for which petitioner has not as yet been reimbursed are carried on petitioner's books as receivables in an account called trust department advances. *Held,* to the extent a payment made by the trust department exceeds the balance in the account to be charged, that payment represents a loan made by petitioner to the trust on behalf of which the payment is made. *Held, further,* the outstanding balance in petitioner's trust department advance account is properly includable in the loan base on which petitioner computes annual additions to its reserve for bad debts under the uniform reserve ratio method. Sec. 166(c), I.R.C. 1954.

FAY, *Judge:* Respondent determined a deficiency of $419,253.17 in the Federal income tax of petitioner, the First National Bank of Chicago, for the year 1968. Certain concessions having been made, it remains for us to decide if respondent properly disallowed a portion of the deduc-

tion claimed by petitioner for an addition to its reserve for bad debts. Sec. 166(c), I.R.C. 1954.[1]

FINDINGS OF FACT

Many of the facts pertinent to this case have been stipulated and are so found.

Petitioner is a national banking association. It filed a U.S. corporation income tax return for the year in issue with the District Director of Internal Revenue, Chicago, Ill. Petitioner's principal place of business was in that same city when the petition herein was filed.

Petitioner serves as the trustee for numerous individual trust and similar accounts. In accordance with regulations issued by the comptroller of the currency, petitioner conducts and accounts for this aspect of its business apart from the others, through its trust department.[2]

The trust department maintains an account ledger for each trust which includes: an income account which reflects the amount of cash held for the income beneficiary of the

[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended.

[2] 12 C.F.R. secs. 9.8 and 9.13 (1974):

Sec. 9.8 Books and accounts.

(a) Every national bank exercising * * * fiduciary powers shall keep its fiduciary records separate and distinct from other records of the bank. * * * The fiduciary records shall contain full information relative to each account.

* * *

Sec. 9.13 Custody of Investments.

(a) The investments of each [fiduciary] account shall be kept separate from the assets of the bank, * * *

(b) The investments of each [fiduciary] account shall be either:

(1) Kept separate from those of all other accounts * * * or

(2) Adequately identified as the property of the relevant account. [28 F.R. 3309, Apr. 5, 1963, as amended at 37 F.R. 24161, Nov. 15, 1972].

trust; a principal account which reflects the amount of cash held for the principal beneficiary; and a securities account which reflects the purchases and sales of all kinds of securities held by the trust, in units rather than dollars.

From time to time, petitioner's trust department makes cash payments on behalf of the trusts which it administers. Each of these payments is chargeable to either the income or the principal account of the trust on behalf of which it is made. When the account to be charged contains insufficient cash to cover a payment, a negative balance called an overdraft results. A transaction that will result in an overdraft will be authorized by a trust officer only when ultimate restoration of the overdraft is reasonably certain. Sources from which repayment is typically anticipated are: periodic returns on trust investments such as dividends and interest; proceeds realized on the liquidation of the trust's investments in securities; additional contributions to the trust by the donor; and funds on deposits with petitioner in existing savings and checking accounts, provided authorization for the release of such funds is obtained from the customer in whose name the account is maintained.

No note is ever executed to evidence an overdraft; neither is a maturity date fixed nor interest charged. Losses incurred by petitioner on overdrafts have been minimal.

When a cash payment is made in an amount which exceeds the balance in the income or principal account to be charged, the additional funds needed to cover the payment are obtained by petitioner's trust department from its commercial loan department through the following device. Each day, the trust department summarizes by trust, the principal and income overdrafts that were outstanding at the close of the preceding working day. If the sum-

maries disclose that on a particular day there was a net increase in overdrafts outstanding over the prior day, the trust department requests a cash advance in the amount of the net increase from the commercial loan department. Such an advance is called a trust department advance (TDA). TDA's are entered on petitioner's books as loans receivable and on the books of the trust department as liabilities. If a daily summary indicates that there has been a net decrease in overdrafts outstanding, the TDA account is commensurately reduced.

Since 1921 petitioner has claimed deductions for bad debts by maintaining a bad debt reserve and by taking deductions for additions to the reserve annually under section 166(c). For the years 1947 through 1964 additions to the reserve were computed by petitioner in accordance with the provisions of Mim. 6209, 1947-2 C.B. 26. Additions for subsequent years including the year in issue were computed under the uniform reserve ratio method provided for in sections 3 through 6 of Rev. Rul. 65-92, 1965-1 C.B. 112.

In making computations under Mim. 6209 and Rev. Rul. 65-92, petitioner has always included the balance in its TDA account in its loan base. On December 31, 1968, the outstanding balance in the account was $19,136,794.50.

Statutory notice of the deficiency at issue herein was mailed on March 9, 1972.

OPINION

Section 166(a) provides that in computing taxable income, a taxpayer may claim deductions for debts which became worthless during the taxable year and, under certain circumstances, for debts which are recoverable only in part and are charged off within the taxable year. Section

166(c) provides that in lieu of any deductions allowable under section 166(a), the taxpayer will, at his option, be allowed a deduction for a reasonable addition to a reserve for bad debts.

The use of the reserve method for deducting bad debts is subject to the reasonable discretion of the Commissioner of Internal Revenue. Sec. 166(c). In an exercise of this discretion he issued Mim. 6209, 1947-2 C.B. 26, on December 8, 1947. Mim. 6209 provided as follows at pages 26-27:

> 1. The Bureau [now the Internal Revenue Service] has given careful and extended consideration to the situation of banks in general with respect to the use of reserves for bad debts, the proper measure of such reserves, and amounts to be allowed as deductions.
>
> 2. In determining a reasonable annual addition to a reserve for bad debt by a bank it is believed to be fair and sufficiently accurate to resort to the average annual bad-debt loss of the bank over a period of 20 years, to include the taxable year, as constituting a representative period in the bank's history and to accept the equivalent percentage of presently outstanding loans as indicative of the probable annual accruing loss. * * *
>
> 3. The Bureau has accordingly approved the use by banks of a moving average experience factor for the determination of the ratio of losses to outstanding loans for taxable years beginning after December 31, 1946. Such a moving average is to be determined on a basis of 20 years, including the taxable year, as representing a sufficiently long period of a bank's experience to constitute a reasonable cycle of good and bad years. The percentage so obtained, applied to loans outstanding at the close of the taxable year, determines the amount of the permissible reserve in the case of a bank changing to the reserve method in such year * * * and the minimum reserve which the taxpayer will be entitled to maintain in future years * * *. A bank, following a change to the reserve method

> of accounting for bad debts, may continue to take deductions from taxable income equal to the current moving average percentage of actual bad debts times the outstanding loans at the close of the year, or an amount sufficient to bring the reserve at the close of the year to the minimum mentioned above, whichever is greater. Such continued deductions will be allowed only in such amounts as will bring the accumulated total at the close of any taxable year to a total not exceeding three times the moving average loss rate applied to outstanding loans * * *[3]

While Mim. 6209 was in effect, additions to reserves for bad debts computed in accordance with its provisions were presumed to be reasonable. The Commissioner might have disallowed deductions claimed for such addition only if he could demonstrate that application of Mim. 6209 was inappropriate in a particular case due to unusual or extraordinary circumstances. *Pullman Trust & Savings Bank* v. *United States*, 235 F.Supp. 317, 323 (N.D. Ill. 1963), affd. per curiam 338 F.2d 666 (7th Cir. 1964); *North Carolina National Bank* v. *United States*, 345 F.2d 544, 549 (Ct. Cl. 1965). Mim. 6209 was proved wanting when applied; for it resulted in an unwarranted variance among the reserves of banks which utilized it. See Rev. Rul. 65-92, 1965-1 C.B. 112, 113. Therefore on March 15, 1965, the Commissioner issued Rev. Rul. 65-92 which superseded Mim. 6209. At pages 113-114 of 1965-1 C.B., Rev. Rul. 65-92 provides:

> Sec. 3. * * *
> * * * a bank will be allowed deductions for additions to its reserve for bad debts until the reserve equals 2.4 percent of loans outstanding at the close of the taxable year * * *
> * * *

[3] On Apr. 8, 1954, the Commissioner issued Rev. Rul. 54-148, 1954-1 C.B. 60, which provided that in computing a reasonable addition to its reserve for bad debts, a bank might use an average experience factor based on any consecutive 20-year period after 1927.

> Sec. 6. * * *
> * * * the addition to the reserve * * * shall not [however] exceed an amount equal to 0.8 percent of loans outstanding at the end of the taxable year, or an amount sufficient to bring the reserve to 0.8 percent of loans outstanding at the end of the taxable year, whichever amount is greater.

This method of computing additions to reserve for bad debts is commonly referred to as the uniform reserve ratio method.[4]

Petitioner elected to compute the additions which it made to its bad debt reserve for 1969 under the uniform reserve ratio method. The Commissioner has conceded that petitioner was entitled to utilize the method. Therefore if petitioner's computations prove to have complied with the method, petitioner will be allowed the deduction which it claimed for 1968 under section 166(c). *Pullman Trust & Savings Bank* v. *United States, supra; North Carolina National Bank* v. *United States, supra*. At issue is whether the computations did in fact meet the requirements of the uniform reserve ratio method.

Petitioner included in the loan base on which the addition was computed, the balance in its TDA account on December 31, 1968. The Commissioner contends that the balance ought not to have been included in the loan base.

In support of this contention, the Commissioner first argues that the TDA's were not loans, pointing out that they were made by petitioner's commercial loan department to its trust department; that none of the TDA's was evidenced

[4] Guidelines published in Rev. Rul. 66-26, 1966-1 C.B. 41, as to the proper application of the uniform reserve ratio method do not concern us here. Nor do modifications of that method introduced in Rev. Rul. 68-524, 1968-2 C.B. 83. Nor are we concerned with the alternate method of computing annual additions to bad debt reserves provided for in Rev. Rul. 65-92.

by a note or had a fixed maturity date; that interest was neither provided for nor paid; and that petitioner never demanded nor sought to enforce repayment.

A loan is the delivery of a sum of money, either to or on behalf of a party who agrees, expressly or impliedly and without condition, to restore at some time in the reasonably proximate future, an amount of money equivalent to the sum delivered. *First Trust & Savings Bank of Davenport, Iowa* v. *United States,* 301 F.Supp. 194, 197 (S.D. Iowa 1969). The record herein discloses that the balance in petitioner's TDA account represented cash payments actually made by petitioner through its trust department on behalf of trusts which the said department administered. Each payment was made with the expectation that petitioner would be reimbursed. In our opinion, the record admits of no other conclusion but that the balance in petitioner's TDA account represented outstanding loans which petitioner made to the trusts administered by its trust department.[5]

Although the balance in the TDA account represents outstanding loans, this does not insure that it qualifies for inclusion in the loan base on which annual additions to petioner's bad debt reserves may be computed. Several principles relevant to the eligibility of loans for inclusion have been developed in Mim. 6209 and several of its progeny. See *First American National Bank of Nashville* v. *United States,* 327 F.Supp. 675, 682 (M.D. Tenn. 1971), affd. 467 F.2d 1098 (6th Cir. 1972).

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[5] Regulations issued by the comptroller of the currency and found at 12 C.F.R. sec. 9.12(f), provide:

(f) A national bank may make a loan to [a fiduciary] account and may take as security therefore assets of the account, provided such transaction is fair to such account and is not prohibited by local law. [28 F.R. 3309, Apr. 5, 1963, as amended at 37 F.R. 24161, Nov. 15, 1972].

On November 19, 1968, the Commissioner issued Rev. Rul. 68-630, 1968-2 C.B. 84, in order—

> to clarify certain questions regarding the eligibility of items for inclusion in the loan base by banks using the uniform reserve ratio method of computing annual additions to reserve for bad debts.

Section 9 of the ruling provides at page 87:

> A bank may compute the addition to its reserve for bad debts on the basis of loans outstanding at the close of its taxable year, except that any loan outstanding on such date that is not representative of the bank's ordinary portfolio of outstanding customer loans must be excluded from the loan base. * * *

The Commissioner argues that if the TDA's are loans, they are excluded from petitioner's loan base under section 9.

In our opinion, section 9 must be interpreted in the context of the two sections of the ruling which precede it.

Section 7 provides at page 86:

> the special methods of determining allowable deductions for additions to reserves for bad debts of banks can only be justified in the context of normal customer loan activities of banks. These methods may not appropriately be applied to the trading or investment aspects of a bank's financial activities. Accordingly, the special reserve methods of accounting for bad debts in the case of banks do not apply to securities.

Section 8 provides at page 87:

> Money market obligations * * * are acquired * * * by banks as part of the continual process of maintaining and adjusting their liquidity position. In this context, money market obligations, like debt securities, are functionally related to the trading or investment position of banks rather than the lending position of banks.

> Accordingly it is held that banks * * * must exclude from the loan base * * * the following money market obligations:
>
> (1) "Sales" or "loans" of Federal funds * * *
>
> (2) "Commercial paper" * * * One example of [which] is short-term promissory notes * * * that may be purchased on the open market.

Sections 7 and 8 distinguish between trading and investment on the one hand, and the lending aspects of a bank's activities on the other. In issuing Rev. Rul. 68-630 it was the Commissioner's purpose to exclude from the loan base obligations acquired by the bank for trading or investment purposes. Sections 7 and 8 give effect to this purpose in respect of the several specific kinds of obligations enumerated in those sections. Section 9 is a broadly phrased rule of exclusion based upon the principle that underlies the two preceding sections. The cash payments represented by petitioner's TDA account are plainly in the nature of customer loans rather than of debt securities or money market obligations. They therefore ought not to be excluded from petitioner's loan base under section 9.

Pursuant to Mim. 6209, the Commissioner issued Rev. Rul. 63-122, 1963-2 C.B. 98. Another of the principles relating to the composition of the loan base, since incorporated into Rev. Rul. 68-630, was stated as follows in Rev. Rul. 63-122, *supra* at 98-99:

> only loans in which an element of risk is present should be considered by a bank in computing additions to bad debt reserves * * *

In the past petitioner has sustained minimal losses on TDA's. The Commissioner argues that the TDA's must therefore be excluded from the loan base as entailing no risk. In respect of this argument we shall first consider the decision of the United States District Court for the

Southern District of Iowa in *First Trust & Savings Bank of Davenport, Iowa* v. *United States, supra.* In that case the plaintiff bank financed customers who wished to build homes by having them execute a first mortgage and mortgage note. When the mortgage had been recorded and its status as a first lien established, the bank would credit the proceeds of the loan to a special account in the customer's name. Disbursements were then made from the account upon order of the customer.

The bank computed annual additions to its bad debt reserve in accordance with Mim. 6209. For the purpose of computing those additions it included in its loan base amounts which had been credited to special borrower accounts, even if they had not as yet been disbursed.

In previous years the bank had suffered no losses on loans of this kind. The Commissioner therefore argued that they should have been excluded from the loan base as entailing no risk. Notwithstanding the record of prior years, the court resolved the controversy in favor of the bank. It rested its decision on the fact that once the loans were approved and the proceeds credited to the special accounts, the funds were available for immediate disbursement on the order of the buyer.

In *Akron National Bank & Trust Co.* v. *United States,* 510 F.2d 1157 (6th Cir. 1975), the plaintiff bank financed construction projects by requiring the customer to execute a note and mortgage once the loan had been approved. The proceeds of the loan were then credited to a special account. Respecting the disposition of the funds in the special account the loan agreement provided:

> [The] proceeds of the loan * * * shall be drawn upon through vouchers in form agreeable to Bank and signed vouchers shall be made payable to subcontractors, contractors and materialmen only, and shall

> be paid by Bank but only after the services and/or materials for which they have been given have been actually installed or completed. In the event such materials or services are defective, Bank may refuse payment therefor until defects therein are corrected. Bank may elect to pay sums to owner, or upon his order from time to time, other than as set forth above but it has no duty to do so. * * * [*Akron National Bank & Trust Co.* v. *United States,* an unreported case (N.D. Ohio 1973, 32 AFTR 2d 73-6091, 73-6092; 73-2 USTC par. 9780).]

The loan agreement further provided that in the event:

> (b) There is any breach of any of the terms or conditions of this agreement or of the mortgage deed or the promissory note * * *;
>
> * * *
>
> (g) Borrower is adjudged bankrupt, suffers the appointment of a receiver, files a petition under Chapter XI of the Bankruptcy Act, or
>
> (h) Borrower requests a termination of the loan or confesses inability to continue construction,
>
> Then, Bank may immediately and without notice declare the loan * * * to be in default, [and] apply all sums remaining in * * * [the] special account to the principal amount of the mortgage indebtedness * * *

The bank computed the annual additions to its bad debt reserve in accordance with the uniform reserve ratio method. In so doing, it included in the loan base the full amount of the construction loans which it had made. The Commissioner took the position that the proceeds of the construction loans could not be included in the loan base while they remained in the special accounts. The court agreed.

The court rested its decision on the fact that the borrower did not have complete control of the funds in the special account established for him. In any one of several circumstances, the bank could have applied the funds in the special account to reduce the principal amount of the indebtedness. In reaching its decision, the court distinguished *First Trust & Savings Bank of Davenport, Iowa* v. *United States, supra,* wherein the proceeds of the loan were completely within the control of the borrower once they were credited to his special account.

On the authority of these decisions we hold that a loan entails an element of risk and is not reasonably excluded from the loan base when the lending bank advances funds without having under its control cash items or balances which it can apply immediately to reduce the amount of the outstanding indebtedness. See *First American National Bank of Nashville* v. *United States, supra* at 681. Our holding is wholly consistent with Rev. Rul. 68-630, *supra,* which provides at page 85 that loans must be excluded from the loan base when the:

> lending bank has rights in specific cash items or cash balances under its control such as when a lending bank receives collateral in the nature of cash on deposit in the lending bank that is represented by a passbook, certificate of deposit, or other similar instrument.
>
> An outstanding loan * * * is not affected by the fact that a borrower is required, by virtue of an arrangement with the lending bank, to maintain a minimum, average, or compensating balance in a demand deposit account within the lending bank while the loan is outstanding. An overdraft in one or more deposit accounts of a customer is an outstanding loan eligible for inclusion in the loan base whether or not other deposit accounts of the same customer have balances in excess of the overdraft.

The record discloses that petitioner made cash disbursements on behalf of the trusts which it administered only when responsible officers were satisfied that reimbursement would be forthcoming. Petitioner did not, however, have at its disposal cash items out of which it could re-

imburse itself unilaterally. The funds which it disbursed on behalf of the trusts were therefore placed at risk.

We therefore hold that petitioner properly included in its loan base for the purpose of applying Rev. Rul. 65-92, the outstanding balance in its TDA account as of December 31, 1968.

Decision will be entered under Rule 155.

COURT OF APPEALS OPINION

The First National Bank of Chicago, Petitioner-Appellee v. Commissioner of Internal Revenue, Respondent-Appellant.

U.S. Court of Appeals, 7th Circuit, No. 76-1284, 12/17/76. Per curiam opinion reversing Tax Court decision, 64 TC 1001, Dec. 33,408.

Before SWYGERT and CUMMINGS, Circuit Judges, and WOLLENBERG, Senior District Judge.*

PER CURIAM: In the taxable year 1968, taxpayer First National Bank of Chicago included $19,136,794.50 of advances to its Trust Department in its loan base for computing its bad debt deduction. Judge Fay of the Tax Court upheld this method and therefore decided that taxpayer had overpaid its income tax by $85,622.12. The Commissioner appealed. We reverse.

As part of its operation, taxpayer maintains a Trust Department and keeps a separate set of books for that department. The Trust Department maintains an income account, a principal account and a securities account for each trust it administers. In making cash disbursements on behalf of trusts, there is sometimes insufficient cash in a particular trust account to cover the disbursements.[1] The appropriate

* Senior District Judge Albert C. Wollenberg of the Northern District of California is sitting by designation.

[1] According to the parties' stipulation of facts, overdrafts occur for the following reasons (Stip. at 6-7);

"(a) Purchase of securities before receipt of the proceeds from a corresponding sale of securities or some other expected funds;

"(b) Payment of taxes, including personal property taxes and estate taxes;

"(c) Fixed income payments to the income beneficiary as provided in the trust agreement;

"(d) Payment of necessary, and possibly unexpected and emergency, living expenses of the income beneficiary;

"(e) Payment of legal fees for the trust incurred in probate proceedings and payment for other professional services, such as for preparation of a trust tax return, and

"(f) Payments in distribution of the trust assets pursuant to a trust agreement before receipt of all liquidation proceeds."

Trust Department officer will then authorize an overdraft when reasonably certain that the advance will be repaid.[2]

When a trust officer authorizes an overdraft, it appears in the individual trust account as a negative or credit figure. The Trust Department daily summarizes the total of all negative balances in individual trust accounts. If the overdrafts show a net increase from the preceding day, taxpayer's Commercial Loan Department advances the amount of that increase to the Trust Department. Such an advance is called a Trust Department Advance (TDA). Taxpayer carries the TDA account on its books as a loan to the Trust Department. The Trust Department books show the TDA account as a liability to taxpayer.

Section 166(c) of the Internal Revenue Code (26 U. S. C. §166(c)) permits "a reasonable addition to a reserve for bad debts" to be deducted as a bad debt in the discretion of the Commissioner.[3] Pursuant to Revenue Ruling 65-92, 1965-1 Cum. Bull. 112, taxpayer computed this deduction under a uniform reserve ratio method which normally allows a bank to deduct additions to its bad debt reserve until the reserve equals 2.4 per cent of the loans outstanding at the end of the taxable year. Taxpayer included the $19,136,794.50 in the TDA account in its loan base in making that computation. The Commissioner determined that

[2] Typical sources of repayment are: periodic payment of dividends and interest on trust investments; proceeds from the liquidation of trust investments; additional contributions to the trust by the settlor; funds on deposit with taxpayer in savings or checking accounts, provided that the customer authorizes the release of such funds. Stip. at 7-8, 15.

[3] Section 166(c) provides:

"*Reserve for Bad Debts.*—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate [the Commissioner]) a deduction for a reasonable addition to a reserve for bad debts." (26 U. S. C. § 166(c))

this was impermissible on the ground that the TDAs were "not representative of the bank's ordinary portfolio of outstanding customer loans" as required by Section 9 of Revenue Ruling 68-630, 1968-2 Cum. Bull. 84.[4] Therefore, he disallowed taxpayer's bad debt deduction to the extent of $459,283.07.[5] However, the Tax Court held that the TDAs were "in the nature of customer loans" and therefore not within the exception of Section 9.[6] Consequently, the TDAs were deemed eligible for inclusion in taxpayer's loan base. *The First National Bank of Chicago* v. *Commissioner* [CCH Dec. 33,408], 64 T. C. 1001 (1975).

As previously noted, under Section 166(c) of the Code, a bad debt deduction for a reasonable addition to a reserve for bad debts is only allowable in the discretion of the Commissioner. Therefore, as the Sixth Circuit observed in

[4] Section 9 of Revenue Ruling 68-630 provides:

"A bank may compute the addition to its reserve for bad debts on the basis of loans outstanding at the close of its taxable year, *except that any loan outstanding on such date that is not representative of the bank's ordinary portfolio of outstanding customer loans must be excluded from the loan base.* If a loan is entered into or acquired for the purpose (whether or not it is the primary purpose) of enlarging the otherwise available bad debt deduction, it will be presumed that the loan resulting from such transaction is not representative of the bank's ordinary portfolio of outstanding customer loans." (Emphasis supplied.)

[5] This figure was arrived at by multiplying the TDA account of $19,136,794.50 by the uniform ratio of 2.4 percent.

[6] The court below did not perceive Section 9 as an independent basis for excluding nonrepresentative loans from the bank's loan base. In Judge Fay's view, Section 9 simply underscored the distinction between customer loans and investment vehicles implicit in the earlier sections of the Revenue Ruling. See text *infra* at 5. Therefore, to be fully accurate, the Tax Court did not find the TDAs to be "in the nature of consumer loans" as a general proposition. Rather, only in a comparative context measuring TDAs against "consumer loans" vis-a-vis investment vehicles, did the court find TDAs to be "in the nature" of the former instead of the latter.

Akron National Bank & Trust Co. v. *United States* [75-1 USTC ¶9256], 510 F.2d 1157, 1161 (6th Cir. 1975), in holding that funds undisbursed from construction loan "Due to Borrowers" accounts were not includable within the total of loans outstanding, the question under Section 166(c) and Revenue Ruling 68-630 is whether the Commissioner's view is reasonable rather than whether the taxpayer's view is reasonable. The Court of Appeals in *Akron* accepted the Court of Claims' interpretation of Section 166(c) in *Paramount Finance Company* v. *United States* [62-2 USTC ¶9531], 304 F.2d 460, 464 (Ct. Cl. 1962), *viz.,* "It does not follow that if the plaintiff [taxpayer] was reasonable in its determination, the defendant [Commissioner] was unreasonable." 510 F.2d at 1161. In *Paramount* Judge Laramore added, "the burden is on the plaintiff to show that the Commissioner was unreasonable, and absent this showing we will not assume that there has been an abuse of discretion."

Taxpayer does not assert that Section 9 of Revenue Ruling 68-630 is unreasonable *per se.* Instead, it first asserts that Section 9 does not constitute an independent basis for excluding non-representative loans from a bank's loan base but rather merely summarizes the "laundry list" of items to be excluded from the bank's loan base under Sections 3 through 8 of the Revenue Ruling. However, the terms of Section 9 lead to the opposite conclusion. The last sentence of Section 9 provides that a loan entered into for the purpose of enlarging the otherwise available bad debt deduction will be presumed not to be representative of the bank's ordinary portfolio of outstanding customer loans. There would be no need for such a provision in Section 9 unless it had an independent function.[7] With due respect, we cannot

accept the construction below that Section 9 merely modifies Sections 7 and 8 of Revenue Ruling 68-630 excluding securities and money market obligations from the loan base (64 T. C. at 1007-1008). Rather, we approve of a subsequent decision of the Tax Court that Section 9 constitutes a separate ground for exclusion of loans from a bank's loan base beyond those exclusions set forth in earlier Sections of that Ruling. *Industrial Valley Bank & Trust Co.* v. *Commissioner* [CCH Dec. 33,822], 66 T. C. 272 (1976).

State Bank of Albany v. *United States,* 76-1 USTC ¶9269 (Ct. Cl. 1976), is not to the contrary. There the Court of Claims held that the words "Government insured loans" in IRS Mim. 6209 (1947-2 Cum. Bull. 26) should be given their plain meaning, excluding state and local government notes. As a result, the court held that certain state notes had been properly included in the bank's loan base for purposes of computing the bank's bad debt reserve. In the present case, giving Section 9 of Revenue Ruling 68-630 its plain meaning results, as we shall see, in excepting the TDAs from the loan base. In contrast to IRS Mim. 6209 which operated to include certain state loans in the Albany Bank's loan base, nothing in the present regulation "brings into effect something analogous to a binding contract" (76-1 USTC at 83,604) that TDAs are meant to be included in a bank's loan base. In addition, the state notes there involved had "a varying element of risk" (*id.* at 83,606) unlike these TDAs, where taxpayer has produced no evidence of a history of default.

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[7] If the first sentence of Section 9 was no more than a broadly-phrased rule of exclusion relying on the principles expressed in Sections 3 through 8 to separate consumer loans from investment vehicles, the second sentence would not be needed. The tax-avoidance loans the second sentence deals with have more indicia of consumer loans than they do of investment activity. Therefore, if the first sentence was only such a broad exclusionary rule, such a rule would operate to allow tax-avoidance loans to be included in a taxpayer's loan base. Yet such "wrongly-motivated" loans are explicitly barred from inclusion into a taxpayer's loan base. Thus the exception clause of the first sentence of Section 9 is a general and independent principle of exclusion of which the "wrongly-motivated" loan of the second sentence is a specific example.

Similarly, *Pullman Trust & Savings Bank* v. *United States,* 235 F.Supp. 317 (N. D. Ill. 1963), affirmed *per curiam,* [64-2 USTC ¶ 9886], 338 F.2d 666 (7th Cir. 1964), does not support taxpayer's position, for it involved only IRS Mim. 6209 rather than anything akin to Section 9 of Revenue Ruling 68-630.

The principal question then becomes whether it was reasonable for the Commissioner to conclude that these TDAs were not representative of taxpayer's ordinary portfolio of outstanding customer loans, so that they must be excluded from the loan base. The reasonableness of the Commissioner's conclusion is apparent when various facets of the TDAs are considered. The Commercial Loan Department received no notes for the overdrafts nor was any interest or other charge imposed with respect to them.[8] Taxpayer made no profit on them, and no maturity dates or repayment schedules were imposed. As one of taxpayer's trust officers testified after studying the bank's records relating to the TDAs since 1968, none of the overdrafts was ever written off as uncollectible. The Tax Court specifically found that losses were minimal. Indeed, the parties stipulated that taxpayer experienced only nominal or *de minimis* losses. The bank's trust officers do not authorize an advance unless they are sure that the trust will receive sufficient funds to repay it. Not only do the advances originate from

[8] Taxpayer offers the following justifications for its failure to make a charge for its TDAs (Br. 4):

"Interest is not charged on Trust Department Advances for a number of reasons. One factor is the fact that positive cash balances of individual trust accounts do not earn interest; thus charging interest on negative balances would be inappropriate. (Tr. 26) In addition, the taxpayer's management made a business decision that trust accounts are good business relationships which may lead to additional commercial banking business. Therefore, interest on trust overdrafts is waived as an inducement to develop trust business. (Tr. 26)"

another department of the bank instead of directly from customers, but they are not even evaluated by taxpayer's commercial loan officers. As seen, the Commercial Loan Department daily advanced any overdraft increases to the Trust Department rather than to borrowers. These factors amply support the reasonableness of the Commissioner's conclusion that the TDAs were not representative of the bank's ordinary portfolio of outstanding customer loans.

Despite these numerous factors demonstrating that TDAs are not representative of taxpayer's ordinary portfolio of outstanding loans, taxpayer asserts that certain unspecified regulations of the Comptroller of the Currency indicate that TDAs should be treated as loans for tax purposes. Taxpayer's Commerical Loan Department maintains two accounts for TDAs. As detailed above, the asset account—"Trust Department Advances"—treats the TDA as a loan receivable. Under instructions issued by the Comptroller, this account must be included by taxpayer in a category termed "other loans" for purposes of taxpayer's call report to the Comptroller. To maintain accounting symmetry, the loan department also keeps a liability account entitled "Trust Department Deposits." This liability account is included in the Federal Deposit Insurance Corporation base on which taxpayer pays assessments and is included in the calculation of taxpayer's reserve requirements under the Federal Reserve System. Conversely, the Trust Department treats TDAs in a liability account—"Trust Advances"—as loans payable, while TDAs are entered in an asset account entitled "Trust Department Deposits." Apparently the Comptroller's regulations also require taxpayer to borrow funds covering these overdrafts from the commercial section of the bank or another appropriate source.

But any regulations of the Comptroller of the Currency requiring that TDAs be accounted for as loans in certain situations are immaterial to whether TDAs are properly loans for purposes of Section 166(c).[9] That Section deals with "loans" definable as a matter of economic reality rather than merely as a matter of accounting formalism. When it is recalled that Section 166(c) of the Code only permits a deduction for a *reasonable* addition to a reserve for bad debts, the instant deduction should not qualify since the record shows that no losses can be anticipated with respect to these TDAs. See *Dixie Furniture Co.* v. *Commissioner* [68-1 USTC ¶9248], 390 F.2d 139, 141 (8th Cir. 1968).

The opinion below recognized that only loans in which an element of risk is present should be considered by a bank in computing additions to bad debt reserves. 64 T. C. at 1008.[10] Yet the Tax Court ignored the factual record in the present case by concluding that "a loan entails an element of risk and is not reasonably excluded from the loan base when the lending bank advances funds without having under its control cash items or balances which it can apply immediately to reduce the amount of outstanding indebtedness" (64 T. C. at 1010). While that is true of many loans, it is not true of these TDAs since no losses have ever occurred.

In contending that TDAs are not within the exception contained in Section 9 of Revenue Ruling 68-630, taxpayer relies on a proposed regulation defining what constitutes a

[9] As the Commissioner points out in his reply brief (p. 2):

"Banks are undoubtedly required to account for Government-insured loans, as well as other advances clearly disqualified from inclusion in their loan bases, as loans by these regulations."

[10] See Revenue Ruling 63-122, 1963-2 Cum. Bull. 98 at 98-99. This principle was incorporated into Revenue Ruling 68-630 (see Sections 4 and 13 thereof), as Judge Fay noted (64 T. C. at 1008).

"loan" eligible for inclusion in the loan base for taxable years beginning after July 1, 1969. That proposal presumes "a loan made in the ordinary course of business of the taxpayer * * * to be representative of the taxpayer's ordinary portfolio of outstanding customer loans."[11] Taxpayer's reliance is misplaced. In the first place, the proposed regulation does not apply to the taxable year 1968. Moreover, the TDAs are arguably not "a loan made in the ordinary course of business of the taxpayer," thus not engaging the presumption. Finally, the proposed regulation has been redrafted to confine eligible loans or debts to those "incurred in the course of the normal customer loan activities of a financial institution * * *."[12] Accordingly, the current draft of the proposed regulation would also seem to exclude TDAs.

Taxpayer next places reliance on the fact that Section 4 of Revenue Ruling 68-630 includes an overdraft "in one or more deposit accounts of a customer" as "an outstanding loan eligible for inclusion in the loan base * * *." Instead of helping taxpayer, Section 4 undermines its position because the Commissioner has only made overdrafts in deposit accounts eligible for inclusion in the loan base. Since the TDAs are not such overdrafts, they must meet the requirement of Section 9 of Revenue Ruling 68-630 and, as seen, they do not qualify under that provision.

Taxpayer also seeks comfort from *First Trust & Savings Bank of Davenport, Iowa* v. *United States* [69-1 USTC ¶9265], 301 F.Supp. 194 (S.D. Ia. 1969), involving home mortgage loans. Section 9 of Revenue Ruling 68-630 was not involved in that case. In any event, the loans there would clearly be representative of the bank's ordinary

[11] Proposed regulation § 1.585(2)-(e)(2)(ii).

[12] See revised proposed regulation § 1.585-2(e)(3)(i) published at 41 Fed. Reg. 40482 (Sept. 20, 1976).

portfolio of outstanding customer loans. Similarly, *First Wisconsin Bankshares Corp.* v. *United States* [74-1 USTC ¶ 9164], 369 F.Supp. 1034 (E.D. Wis. 1973), did not concern Section 9 of Revenue Ruling 69-630. Even if it had, the construction loans made to three non-profit corporations would seem to be typical customer loans and therefore within Section 9.

Finally, taxpayer asserts that the April 13, 1964, closing agreement entered into with the Commissioner under 26 U. S. C. § 7121 bars him from excluding these TDAs from its 1968 loan base. The statute accords finality only to the very agreement, and it was specifically confined to the amount of the bank's reserve for bad debts on January 1, 1958, and does not estop the Commissioner in later years.[13] *Dixie Furniture Co.* v. *Commissioner* [68-1 USTC ¶ 9248], 390 F.2d 139, 141-142 (8th Cir. 1968).

Under the test adopted in the *Akron National Bank & Trust Co., supra,* and other cases,[14] we hold that the Commissioner's application of Section 166(c) and Section 9 of Revenue Ruling 68-630 to these facts was reasonable. There being no abuse of discretion on the Commissioner's part, taxpayer may not enlarge its bad debt reserve to cover the TDAs.

The decision of the Tax Court is reversed.

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[13] Indeed, as the Commissioner points out in his reply brief (pp. 9-10):

"* * * if taxpayer's position is correct—that the agreement has the effect of binding both parties to computing the reserve in the same manner as that used in the closing agreement—taxpayer would not be entitled to use the method set forth in Rev. Rul. 65-92, 1965-1 Cum. Bull. 112, as clarified by Rev. Rul. 68-630, *supra,* since the 1958 balance as agreed was computed under Mim. 6209, 1974-2 Cum. Bull. 26, which was superseded by Rev. Rul. 65-92, *supra.*"

[14] See, *e.g., Merchants Industrial Bank* v. *Commissioner* [73-1 USTC ¶ 9298], 475 F.2d 1063, 1065 (10th Cir. 1973); *American State Bank* v. *United States* [62-2 USTC ¶ 9519], 279 F.2d 585, 589-590 (7th Cir. 1960), certiorari denied, 364 U.S. 891.

STATUTE AND RULINGS INVOLVED

INTERNAL REVENUE CODE OF 1954

SEC. 166. BAD DEBTS.

(a) General Rule.—

(1) Wholly worthless debts.—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially worthless debts.—When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) Amount of Deduction.—For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) Reserve for Bad Debts.—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

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MIMEOGRAPH 6209

Section 29.23(k)-5: Reserve for bad debt.

Reserve method of accounting for bad debts in the case of banks.

Treasury Department,
Office of Commissioner of Internal Revenue,
Washington 25, D. C., December 8, 1947.

Collectors of Internal Revenue, Internal Revenue Agents in Charge, Technical Staff, and Others Concerned:

1. The Bureau has given careful and extended consideration to the situation of banks in general with respect to the use of reserves for bad debts, the proper measure of such reserves, and amounts to be allowed as deductions.

2. In determining a reasonable annual addition to a reserve for bad debts by a bank it is believed to be fair and sufficiently accurate to resort to the average annual bad-debt loss of the bank over a period of 20 years, to include the taxable year, as constituting a representative period in the bank's history and to accept the equivalent percentage of presently outstanding loans as indicative of the probable annual accruing loss. The Tax Court has held that the "use of the reserve for bad debts is not inherently inconsistent with a cash basis where, as here, the reserve is against loss of capital only * * * and contains no element of income which has never been reported. * * * Such a reserve for loss of capital does not differ materially from a reserve for depreciation which is set up on a percentage basis rather than on the basis of actual depreciation suffered." (See *Estate of Maurice S. Saltstein* v. *Commissioner*, 46 B. T. A., 774, 777, acquiescence, C. B. 1942-1, 14.) However, such reserve can not be permitted to accumulate indefinitely simply because of the possibility that at some future date large losses may be concentrated within a relatively short period of time and operate to absorb the greatest probable reserve. To permit this would sanction the deduction of a mere contingency reserve for losses, which is not an allowable deduction for income or excess profits tax purposes. This latter rule makes imperative the imposition of some reasonable ceiling on the accumulation of the reserve other than such indefinite limitation as might eventually prevail under a moving average method.

3. The Bureau has accordingly approved the use by banks of a moving average experience factor for the determination of the ratio of losses to outstanding loans for taxable years beginning after December 31, 1946. Such a moving average is to be determined on a basis of 20 years, including the taxable year, as representing a sufficiently long period of a bank's experience to constitute a reasonable cycle of good and bad years. The percentage so obtained, applied to loans outstanding at the close of the taxable year, determines the amount of permissible reserve in the case of a bank changing to the reserve method in such year (see first year in following computation) and the minimum reserve which the taxpayer will be entitled to maintain in future years (see second year in following computation). A bank, following a change to the reserve method of accounting for bad debts, may continue to take deductions from taxable income equal to the current moving average percentage of actual bad debts times the outstanding loans at the close of the year, or an amount sufficient to bring the reserve at the close of the year to the minimum mentioned above, whichever is greater. Such continued deductions will be allowed only in such amounts as will bring the accumulated total at the close of any taxable year to a total not exceeding three times the moving average loss rate applied to outstanding loans (see fifth year in following computation).

Example of the application of the foregoing with amount of outstanding loans remaining unchanged at $1,000,000.

Year.	Moving average percent-age.	Actual bad debts for year.	Deduction.	Reserve at end of year.	Ceiling.
1	1.0	$ 2,000	$12,000	$10,000	$30,000
2	.8	11,500	9,500	8,000	24,000
3	.7	1,000	7,000	14,000	21,000
4	.8	1,000	8,000	21,000	24,000
5	1.0	500	9,500	30,000	30,000

4. In computing the moving average percentage of actual bad debt losses to loans, the average should be computed on loans comparable in their nature and risk involved to those outstanding at the close of the current taxable year involved. Government insured loans should be eliminated from prior year accounts in computing percentages of past losses, also from the current year loans in computing allowable deductions for additions to the reserve. Losses not in the nature of bad debts resulting from the ordinary conduct of the present business should also be eliminated in computing percentages of prior losses.

5. A newly organized bank or a bank without sufficient years' experience for computing an average as provided for above will be permitted to set up a reserve commensurate with the average experience of other similar banks with respect to the same type of loans, preferably in the same locality, subject to adjustment after a period of years when the bank's own experience is established.

6. Bad debt losses sustained are to be charged to the reserve, and recoveries made of specific debts which have been previously charged against the reserve by a bank on the reserve method of treating bad debts should be credited to the reserve.

7. Where a bank making its return on the basis of the calendar year 1947 wishes to avail itself of the provisions of this mimeograph and to change from the specific charge-off to the reserve method of accounting for bad debts, the time for making application for such change under section 29.23(k)—1, Regulations 111, has been extended to March 15, 1948 (T.D. 5594, approved December 8, 1947 [page 25, this Bulletin]). If such bank files its return on or before March 15, 1948, on the reserve method, and the return is accompanied by a written statement setting forth the election to use such method and explaining in detail the computations of the bad debt deduction shown in the return, such return will be accepted as a timely application.

8. The term "banks" as used herein means banks or trust companies incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts.

9. Correspondence in regard to this mimeograph should refer to the number and to the symbols IT:EIM.

GEO. J. SCHOENEMAN,
Commissioner.

Approved December 8, 1947.
A. L. M. WIGGINS,
Acting Secretary of the Treasury.

REVENUE RULING 65-92

SECTION 1. PURPOSE.

The purpose of this Revenue Ruling is to provide a uniform percentage for computing annual additions to re-

serves for bad debts by banks in order to minimize the large differences in permissible reserves now existing among banks under prior rulings.

SEC. 2. BACKGROUND.

Section 166(a) of the Internal Revenue Code of 1954 allows a deduction for a debt which became worthless during the taxable year and, under certain circumstances, for a debt which is recoverable only in part and is charged off within the taxable year. Section 166(c) of the Code provides that, in lieu of any deduction under section 166(a) of the Code, there shall be allowed (in the discretion of the Secretary or his delegate), a deduction for a reasonable addition to a reserve for bad debts.

Mimeograph 6209, C.B. 1947-2, 26, authorized, in the case of banks, a special method for computing an annual addition to the reserve for bad debts. Under this method, a bank's bad debt reserve ceiling was computed by reference to a moving average experience factor for determining the ratio of losses to loans on the basis of 20 years of experience, including the taxable year. For any portion of such 20-year period during which a bank was not in existence, the bank was authorized to use the average experience of other similar banks with respect to the same type of loans.

Revenue Ruling 54-148, C.B. 1954-1, 60, supplemented Mimeograph 6209 and authorized a bank to use an average experience factor based on any 20 consecutive years of experience after 1927.

The Internal Revenue Service has reexamined the above rulings in the light of the experience developed thereunder. The rulings have resulted in large variances in reserves among banks and in reserve ceilings not related to the probability of bad debts on outstanding loans.

The Service has therefore approved a revised special method for use by banks which is designed to minimize the existing large variances in permissible reserves. This method, which is set forth in sections 3 through 6 of this Revenue Ruling and which utilizes a uniform ratio of 2.4 percent of outstanding loans, has been approved by the Service in view of the reserve levels previously established by banks, and the special circumstances applicable to the banking industry. This method will not be used by the Service as a precedent for determining reasonable additions to reserves for bad debts by taxpayers other than banks.

SEC. 3. UNIFORM RESERVE RATIO.

In lieu of reserve computations made through the use of a loss experience factor determined on an individual basis as provided in section 7 of this Revenue Ruling, a bank will be allowed deductions for additions to its reserve for bad debts until the reserve equals 2.4 percent of loans outstanding at the close of the taxable year, subject to the exceptions and limitations prescribed in sections 4, 5, and 6 of this Revenue Ruling.

SEC. 4. RESERVE LESS THAN UNIFORM RATIO.

If the dollar balance of a bank's reserve, as of the close of its taxable year immediately preceding the year of the change, is less than 2.4 percent of loans outstanding at such time, the amount of the difference (referred to herein as the deficiency in the reserve) may be included in the bank's annual addition to the reserve in an amount not exceeding one-tenth of the deficiency in the reserve, commencing with

the year of the change. Such amount need not be added in any specific taxable year but not more than one-tenth of the deficiency will be permitted in any one year. A bank computing its annual reserve addition under this section will also be permitted to include in such addition an amount equal to net bad debts charged to the reserve during the year. Further, it will be permitted to include in such addition 2.4 percent of the increase in its loans outstanding at the end of the taxable year over loans outstanding at the end of the year preceding the year of change, to the extent that a reserve addition with respect to such increase has not been taken in a prior year. The sum of the foregoing amounts, however, may not exceed an amount sufficient to increase the reserve to 2.4 percent of outstanding loans at the end of the taxable year. Thus, if a decrease in a bank's year-end outstanding loans has resulted in a reserve ratio in excess of 2.4 percent, no addition to the reserve would be permitted for that year. If a bank changes to the reserve method of accounting, it shall be treated, for purposes of this section, as having a reserve of zero for the taxable year immediately preceding the year of the change.

SEC. 5. RESERVE EXCEEDING UNIFORM RATIO.

If the dollar balance of a bank's reserve, as of the close of its taxable year ending in 1964, exceeds 2.4 percent of loans outstanding at such time, the addition to the reserve in any taxable year shall not increase the reserve above the greater of (i) such dollar balance, or (ii) 2.4 percent of loans outstanding at the close of the taxable year. Thus, a bank which has reserves exceeding 2.4 percent of outstanding loans may maintain the dollar balance of its reserve by making additions to its reserve equal to the net amount of bad debts charged to the reserve during the year. Notwithstanding the preceding rules of this section, if the

amount of loans outstanding at the close of the taxable year is less than the amount of loans outstanding at the close of the taxable year ending in 1964, the addition to the reserve shall not increase the reserve at the close of the taxable year to a percentage of outstanding loans which is larger than the percentage which the reserve bore to outstanding loans at the close of the taxable year ending in 1964.

SEC. 6. MAXIMUM ANNUAL RESERVE ADDITION.

Notwithstanding the provisions of sections 4 and 5 of this ruling, the addition to the reserve that a bank will be permitted in a taxable year through the use of the uniform reserve ratio shall not exceed an amount equal to 0.8 percent of loans outstanding at the end of the taxable year, or an amount sufficient to bring the reserve to 0.8 percent of loans outstanding at the end of the taxable year, whichever amount is greater.

SEC. 7. PROBABLE EXPERIENCE METHOD.

In lieu of reserve computations made through the use of the uniform reserve ratio under sections 3 through 6 of this Revenue Ruling, a bank may compute its annual reserve additions under the method provided in this section. If a bank so computes its addition, it must establish, to the satisfaction of the District Director of Internal Revenue, that the amount computed is necessary in order to absorb the bad debts probably arising on loans outstanding at the close of the taxable year. In such event, the reasonableness of the proposed addition for the taxable year shall be determined under the provisions of section 166(c) of the Code in light of the facts existing at the close of such year. Thus, the reasonableness of the addition shall depend upon the total amount of the existing reserve and current business

conditions, the nature of the bank's loans, the bank's past experience, and other factors, which may reasonably be expected to have a significant effect on the collection of the loans outstanding at the close of the taxable year. The reasonableness of the addition shall not, however, be based upon mere speculation, possibility, or contingency. For purposes of this section, the addition to the reserve for any taxable year will be regarded as reasonable if it does not increase the balance of the reserve (as of the close of such year) above an amount equal to the total amount of loans outstanding at the close of such year multiplied by the "moving average experience percentage" for such year. In determining the moving average experience percentage, reference shall be made to the bad debt experience of the bank with respect to its loans for a 6-year period comprising the taxable year and the 5 preceding taxable years. The moving average percentage shall be computed as the ratio which the total amount of net bad debts sustained on loans during such 6-year period bears to the sum of the total amounts of loans outstanding at the close of each taxable year in such period.

If the bank has not been in existence for the full 6-year period, then, for the portion of such period during which it was not in existence, the taxpayer may use the average bad debt experience of comparable banks with respect to comparable loans.

SEC. 8. DEFINITIONS OF TERMS.

.01 The term "banks" as used herein means banks or trust companies incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts. Such term

does not include a mutual savings bank not having capital stock represented by shares, a domestic building and loan association as defined in section 7701(a)(19) of the Code, or a cooperative bank as defined in section 7701(a)(32) of the Code.

.02 The term "loans" as used in sections 3 through 6 of this ruling does not include Government insured or guaranteed loans to the extent so insured or guaranteed.

.03 The term "the year of change" means the first taxable year ending after December 31, 1964, or, in the case of a bank changing from the specific charge-off method to the reserve method in a later year, the year in which the change is made.

SEC. 9. BANKS ON SPECIFIC CHARGE-OFF METHOD.

Where a bank on the specific charge-off method of accounting for bad debts desires to change to the reserve method, application to make such a change shall be made in the manner prescribed by section 3 of Revenue Procedure 64-51, C.B. 1964-2, 1003, but the amount of the reserve at the end of the year of change and subsequent years shall be determined in accordance with the provisions of this Revenue Ruling.

SEC. 10. EFFECTIVE DATE.

The provisions of this Revenue Ruling are applicable for taxable years ending after December 31, 1964.

SEC. 11. EFFECT ON OTHER DOCUMENTS.

Mimeograph 6209, C.B. 1947-2, 26, and Revenue Ruling 54-148, C.B. 1954-1, 60, are hereby superseded. Section 4.02 of Revenue Procedure 64-51, C.B. 1964-2, 1003 (relating to change in accounting method), and Revenue Ruling 57-210,

C.B. 1957-1, 94, Revenue Ruling 58-259, C.B. 1958-1, 116, Revenue Ruling 57-509, C.B. 1957-2, 145, Revenue Ruling 63-122, C.B. 1963-2, 98, and G.C.M. 25605, C.B. 1948-1, 38 (relating to the term "loans"), are hereby modified to remove therefrom the references to Mimeograph 6209 and Revenue Ruling 54-148, and substitute in place thereof reference to this Revenue Ruling for taxable years ending after December 31, 1964.

REVENUE RULING 68-630[1]

SECTION 1. PURPOSE.

The purpose of this Revenue Ruling is to clarify certain questions regarding the eligibility of items for inclusion in the loan base by banks using the uniform reserve ratio method of computing annual additions to reserves for bad debts.

SEC. 2. BACKGROUND.

Section 166(a) of the Internal Revenue Code of 1954 allows a deduction for a debt that became worthless during the taxable year and, under certain circumstances, for a debt that is recoverable only in part and is charged off within the taxable year. Section 166(c) of the Code provides that, in lieu of any deduction under section 166(a) of the Code, there shall be allowed (in the discretion of the Secretary of the Treasury or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

Revenue Ruling 65-92, C.B. 1965-1, 112, provides a revised special method for use by banks for taxable years ending after December 31, 1964, designed to minimize the large variances in permissible reserves that had existed.

[1]Also released as News Release IR-947, dated Nov. 19, 1968.

This method, set forth in Sections 3 through 6 of Revenue Ruling 65-92, utilizes a uniform ratio of 2.4 percent of outstanding loans at the close of the taxable year. Although Revenue Ruling 65-92 indicates that "Government insured or guaranteed loans to the extent so insured or guaranteed" are not to be considered as within the loan base, that Revenue Ruling does not undertake to resolve certain questions with regard to the composition of the loan base upon which allowable annual additions to a reserve for bad debts are to be computed. Revenue Ruling 65-92 has been supplemented by Revenue Ruling 66-26, C.B. 1966-1, 41, which provides guidelines for use by banks in computing bad debt reserves. Those Revenue Rulings have been modified by Revenue Ruling 68-524, page 83, this Bulletin, with respect to the scope of the term "bank."

SEC. 3. INTERBANK DEPOSITS AND LOANS.

Bank funds on deposit in another bank (as defined in section 581 of the Code) or in a foreign bank are not eligible for inclusion in the loan base upon which allowable deductions for additions to a reserve for bad debts are computed. This would include any funds represented by a certificate of deposit or any other form of instrument evidencing the deposit of a sum of money with the issuing bank that will be available for withdrawal on or after a given date or period of time. A loan to a bank (as defined in section 581 of the Code), and a loan to a branch or agency of a foreign bank engaged in the banking business in the United States that may be entitled to compute the addition to its reserve for bad debts under Revenue Ruling 65-92 (see Revenue Ruling 68-524), are not eligible for inclusion in the loan base irrespective of whether they take the form of repurchase agreements or similar transactions. See Revenue Ruling 68-3, C.B. 1968-1, 75.

SEC. 4. CASH COLLATERAL.

Revenue Ruling 63-122, C.B. 1963-2, 98, holds, in part, that for the purpose of computing reasonable annual additions to its reserve for bad debts a bank is required to decrease the face amount of installment loans outstanding by the amount of any so-called "hold back" accounts related to such installment loans. As described in that ruling "hold back" accounts are in the nature of guarantee deposits left with the bank by dealers discounting installment paper. Revenue Ruling 63-122 also is applicable to the extent that a lending bank has collected and retained cash derived from collateral pledged to the bank and to the extent that loan payments made by a borrower are maintained in a separate account and are not immediately credited to the outstanding loan balance.

The underlying concept behind Revenue Ruling 63-122 is applicable to other situations in which a lending bank has rights in specific cash items or cash balances under its control such as when a lending bank receives collateral in the nature of cash on deposit in the lending bank that is represented by a passbook, certificate of deposit, or other similar instrument.

An outstanding loan otherwise eligible for inclusion in the loan base is not affected by the fact that a borrower is required, by virtue of an arrangement with the lending bank, to maintain a minimum, average, or compensating balance in a demand deposit account within the lending bank while the loan is outstanding. An overdraft in one or more deposit accounts of a customer is an outstanding loan eligible for inclusion in the loan base whether or not other deposit accounts of the same customer have balances in excess of the overdraft.

Loans secured by collateral such as passbooks, certificates of deposit, or other similar instruments representing cash on deposit in a bank (as defined in section 581 of the Code) or in a branch or agency of a foreign bank engaged in the banking business in the United States that may be entitled to compute the addition to its reserve for bad debts under Revenue Ruling 65-92 (see Revenue Ruling 68-524), other than the lending bank, must be excluded from the loan base to the extent that the lending bank may control withdrawal of such cash deposits. These principles do not apply to collateral representing sums held by non-banking institutions.

SEC. 5. UNEARNED DISCOUNT OR INTEREST RECEIVABLE.

Any unearned discount or interest receivable reflected in the face amount of outstanding loans but not realized and reported as income must be excluded from the loan base of banks using the reserve method. See Revenue Ruling 63-122.

SEC. 6. GOVERNMENT INSURED OR GUARANTEED LOANS.

Revenue Ruling 65-92 provides that Government insured or guaranteed loans must be excluded from the loan base to the extent so insured or guaranteed. See also Revenue Ruling 58-259, C.B. 1958-1, 116; Revenue Ruling 57-509, C.B. 1957-2, 145; Revenue Ruling 57-210, C.B. 1957-1; 94; and *Miners National Bank of Wilkes-Barre* v. *Commissioner,* 33 T.C. 42 (1959).

The term "Government insured or guaranteed loans" includes both direct loans to a "Government" as well as loans to a third party that are insured or guaranteed, directly or indirectly, by a "Government." In the case of loans to

third parties, however, the amount to be excluded from the loan base is limited to that portion of such loans that are insured or guaranteed by a "Government."

The term "Government" as used in the cited Revenue Rulings is to be interpreted as having reference to the Federal Government and its instrumentalities, the District of Columbia, Territories or possessions of the United States, and State governments and political subdivisions thereof. Compare section 103 of the Code. Loans to foreign governments, therefore, are includible in the loan base unless insured or guaranteed by a "Government" as that term is used in this section.

SEC. 7. INVESTMENTS IN DEBT SECURITIES.

Section 582(a) of the Code provides that losses arising from the worthlessness of securities, as that term is defined in section 165(g)(2)(C) of the Code, may be deducted as ordinary debt losses under section 166 of the Code rather than as capital losses from worthless securities under section 165 of the Code. However, the special methods of determining allowable deductions for additions to reserves for bad debts of banks can only be justified in the context of the normal customer loan activities of banks. These methods may not appropriately be applied to the trading or investment aspects of a bank's financial activities. Accordingly, the special reserve methods of accounting for bad debts in the case of banks do not apply to securities.

Banks using the methods provided by Revenue Ruling 65-92 for determining allowable deductions for additions to a reserve for bad debts must therefore exclude investments in securities, as that term is used in section 165(g)(2)(C) of the Code, from the loan base upon which such deductions are determined.

SEC. 8. MONEY MARKET INVESTMENTS.

Money market obligations form part of an objective market, and are acquired and disposed of by banks as part of the continual process of maintaining and adjusting their liquidity position. In this context, money market obligations, like debt securities, are functionally related to the trading or investment position of banks rather than the lending position of banks.

Accordingly, it is held that banks using the uniform reserve ratio method specified in Revenue Ruling 65-92 must exclude from the loan base upon which annual additions to a reserve are calculated the following money market obligations:

(1) "Sales" or "loans" of Federal funds irrespective of the purchaser or borrower.

(2) "Commercial paper" however acquired by the taxpayer bank. One example of commercial paper is short-term promissory notes (less than 1 year and generally of 4 to 6 months duration) that may be purchased on the open market.

A bankers acceptance purchased or discounted by a bank is includible in its loan base. Customer's liability to the originating bank on acceptances outstanding, however, must be excluded from the loan base of the originating bank, since such liability merely represents the future extension of credit with respect to which no money has been advanced by the originating bank.

SEC. 9. DETERMINATION OF A REPRESENTATIVE LOAN BASE.

A bank may compute the addition to its reserve for bad debts on the basis of loans outstanding at the close of its taxable year, except that any loan outstanding on such date that is not representative of the bank's ordinary portfolio

of outstanding customer loans must be excluded from the loan base. If a loan is entered into or acquired for the purpose (whether or not it is the primary purpose) of enlarging the otherwise available bad debt deduction, it will be presumed that the loan resulting from such transaction is not representative of the bank's ordinary portfolio of outstanding customer loans.

SEC. 10. EXTENT OF APPLICATION WITHOUT RETROACTIVE EFFECT.

The position stated in this Revenue Ruling clarifies certain questions that have arisen concerning computation of the loan base but does not represent a change in a previously published position of the Internal Revenue Service. It would, therefore, normally be applied to all open taxable years. However, in view of the nature of the deduction for additions to a reserve for bad debts, over-all tax deductions to taxpayers here involved would not be significantly affected by the timing of the application of this Revenue Ruling. Therefore, under the authority of section 7805(b) of the Code, the position stated herein will not be applied by the Service to deductions claimed for taxable years ending on or before November 30, 1968, to the extent that such deductions were based on inclusion of the following items in the loan base:

(1) Loans to other banks. See section 3 of this Revenue Ruling.

(2) Loans with respect to which the lender receives collateral in the nature of cash on deposit in the lending bank or another bank that is represented by a passbook, certificate of deposit or other similar instrument. See section 4.

(3) Loans to or loans insured or guaranteed by political subdivisions of a State government, except to the extent such loans are insured or guaranteed by a State government. See section 6.

(4) "Sales" or "loans" of Federal funds. See section 8.

(5) Commercial paper. See section 8.

The amount of the deduction for an addition to the reserve for bad debts for a taxable year must be based upon the amount contemporaneously entered on the taxpayer's books during the taxable year, or as soon as practicable after the close of the taxable year, and cannot be subsequently increased.

SEC. 11. TRANSITIONAL ADJUSTMENTS.

If the amount of a bank's outstanding loans for a taxable year ending after November 30, 1968, is less than the amount of loans outstanding at the close of the taxable year of the bank ending on or before November 30, 1968, solely as a result of the exclusion of the items in section 10, then such bank may maintain the dollar balance of its reserve as of the close of the taxable year ending on or before November 30, 1968, by making additions to its reserve equal to the net amount of bad debts charged to the reserve during the taxable year, subject to the overall limitation of section 6 of Revenue Ruling 65-92. However, no addition to its reserve for bad debts for the taxable year is permitted to a bank that computes its bad debt reserves under section 4 of Revenue Ruling 65-92, to the extent that such reserve for the taxable year would exceed 2.4 percent of loans outstanding computed without regard to exclusion of the items in section 10.

If the amount of a bank's outstanding loans for a taxable year ending after November 30, 1968, is less than the amount of loans outstanding as of the close of its taxable

year preceding the year of change (see section 6 of Revenue Ruling 66-26), solely as a result of the exclusion of the items in section 10, then such bank may maintain the dollar balance of its reserve as of the close of its taxable year preceding the year of change by making additions to its reserve equal to the net amount of bad debts charged to the reserve during the taxable year, subject to the overall limitation of section 6 of Revenue Ruling 65-92.

If the decline in the loans outstanding for a taxable year is only partially as a result of the exclusion of the items in section 10, then the bank may make additions to its reserve for bad debts in the taxable year, to the extent of the net amount of bad debts charged to the reserve during the taxable year, that would be permitted had the excluded items been included in the loan base.

SEC. 12. TREATMENT OF EXCLUDED ITEMS.

Losses on worthless securities are not to be charged against the bad debt reserve established under Revenue Ruling 65-92. See section 7 of this Revenue Ruling. Insofar as a bank coming within the definition of section 581 of the Code is concerned, deductions for losses on securities may be taken either as specific bad debt losses or may be taken through the creation of a separate loss reserve on such securities established without respect to Revenue Ruling 65-92. See section 582(a) of the Code. Insofar as a bank that does not meet the definition of section 581 of the Code is concerned, deductions for losses on securities are to be treated as provided in section 165 of the Code. See section 582(a) of the Code and Revenue Ruling 68-524. Losses on all other items that are excluded from the loan base of banks using the uniform reserve ratio method of determining

additions to a reserve for bad debts are not to be charged against the reserve but may be deducted as a specific debt loss under section 166 of the Code. See Revenue Ruling 68-3.

SEC. 13. EFFECT ON OTHER DOCUMENTS.

Revenue Ruling 63-122 is hereby clarified. Revenue Ruling 65-92, as supplemented by Revenue Ruling 66-26, and as modified by Revenue Ruling 68-524, is hereby further supplemented.

No. 76-1263

In the Supreme Court of the United States

OCTOBER TERM, 1976

THE FIRST NATIONAL BANK OF CHICAGO, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

WADE H. McCREE, JR.,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.

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The question presented in this federal income tax case is whether petitioner, a national bank, can deduct $459,283.07 as an addition to its bad debt reserve for 1968.

Section 166(c) of the Internal Revenue Code of 1954 (26 U.S.C.) permits taxpayers to deduct, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts. Petitioner elected to compute this deduction under the uniform reserve ratio prescribed by Rev. Rul. 65-92, 1965-1 Cum. Bull. 112, which generally allows a bank to deduct additions to its bad debt reserve until the reserve equals 2.4 percent of the loans outstanding at the end of the taxable year. The prerequisites for inclusion of an item or amount in a bank's loan base were clarified in Rev. Rul. 68-630, 1968-2 Cum. Bull. 84, which excluded, *inter alia,* "loans

* * * not representative of the bank's ordinary portfolio of outstanding customer loans." Section 9, Rev. Rul. 68-630, *supra*.

In computing its outstanding loan base for 1968, petitioner included $19,136,794.50 of advances to its own trust department.[1] The Commissioner excluded these advances from petitioner's loan base because they were "not representative of the bank's ordinary portfolio of outstanding customer loans" as Section 9 of Rev. Rul. 68-630, *supra*, required. The Tax Court ruled that the advances were includable in petitioner's loan base (Pet. App. A-1 to A-14). The court of appeals reversed. It held that the Commissioner reasonably determined, within his discretion, that petitioner could not enlarge its bad debt reserve to cover its trust department advances because those advances were not typical examples of its outstanding loans (Pet. App. A-15 to A-24).[2]

1. The court of appeals correctly held that the Commissioner did not abuse his discretion in excluding the trust department advances from petitioner's loan base for purposes of computing its allowable bad-debt reserve. This decision is consistent with those of other appellate

[1]Petitioner's advances to its trust department arose because the trust department made cash disbursements on behalf of trust accounts which temporarily had insufficient cash to cover the disbursements. The advances were authorized when the trust department officer was reasonably certain that the advance would be repaid (Pet. App. A-15 to A-16).

[2]The question presented has little administrative importance. For taxable years beginning after July 11, 1969, Section 585(b)(4) of the Code requires the Commissioner to promulgate regulations defining loans eligible for inclusion in the loan base. As the court of appeals noted (Pet. App. A-22 to A-23), petitioner's advances to its trust department would not qualify for inclusion in its loan base under the proposed regulations.

courts holding that the Commissioner's determination with respect to the computation of a bad-debt reserve must be sustained unless it is "unreasonable," or an abuse of his discretion. See, *e.g., Akron National Bank & Trust Co.* v. *United States*, 510 F. 2d 1157 (C.A. 6); *Merchants Industiral Bank* v. *Commissioner*, 475 F. 2d 1063 (C.A. 10); *American State Bank* v. *United States*, 279 F. 2d 585 (C.A. 7), certiorari denied, 364 U.S. 891; and *Paramount Finance Co.* v. *United States*, 304 F. 2d 460 (Ct. Cl.).

Here, the court observed that petitioner's advances to its trust department for temporary advances on behalf of trust accounts were not includable in its loan base because the commercial loan department did not receive any notes or charge any interest for the advances to its trust department, did not impose any maturity dates or repayment schedules, and suffered only *de minimis* losses. Moreover, the advances were not evaluated by petitioner's commercial loan officers (Pet. App. A-20 to A-21). Under these circumstances, the court of appeals properly concluded that petitioner's trust department advances represented no risk and were not representative of its ordinary portfolio of outstanding customer loans, and that the Commissioner properly excluded them from the loan base.[3]

2. As the court of appeals recognized (Pet. App. A-19 to A-20), its decision does not conflict with *State Bank of Albany* v. *United States*, 530 F. 2d 1379 (Ct. Cl.), and *North Carolina National Bank* v. *United States*, 345 F. 2d 544 (Ct.

[3]Moreover, petitioner's reliance on Section 4 of Rev. Rul. 68-630, *supra*, which specifies that "an overdraft in one or more deposit accounts of a customer is an outstanding loan eligible for inclusion in the loan base," is misplaced. As the court of appeals noted (Pet. App. A-23), petitioner's trust department advances are not overdrafts in deposit accounts.

Cl.), or with *Pullman Trust & Savings Bank* v. *United States*, 338 F. 2d 666 (C.A. 7), affirming 235 F. Supp. 317 (N.D. Ill.). *State Bank of Albany* and *North Carolina National Bank* involved the interpretation of the now-superseded Mim. 6209, 1947-2 Cum. Bull. 26,[4] which authorized banks to compute annual additions to their bad debt reserves by reference to an average experience factor representing the ratio of losses to loans over a 20-year period. But the question presented in those decisions involved the inclusion of state and local government notes in the taxpayer's loan base and not the particular intra-bank advances of the type at issue here. While the Court of Claims held that Mim. 6209 was analogous to a contract so that an ambiguity in Mim. 6209 must be resolved against the Commissioner, there is no ambiguity in Rev. Rul. 68-630, the operative ruling in this case. As the court of appeals observed (Pet. App. A-19), the plain meaning of Section 9 of that ruling requires the exclusion of petitioner's trust department advances from its loan base.[5]

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.,
Solicitor General.

APRIL 1977.

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[4] Mim. 6209 was superseded by Rev. Rul. 65-92, *supra*, which in turn was amplified by Rev. Rul. 68-630, *supra*.

[5] *Pullman Trust & Savings Bank* v. *United States, supra*, is likewise distinguishable. There, the court held that the Commissioner had properly exercised his discretion in promulgating Mim. 6209, and that a taxpayer's computation in accordance with that ruling was presumed to be reasonable (235 F. Supp. at 323). The decision did not address the includability of the trust department advances involved here.

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